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THE SPILLOVER OF THE COFFEE: MATERIAL MISSTATEMENTS AT (UN) LUCKIN COFFEE INC.

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ABSTRACT

The research investigates alleged material misstatements in the financials of Luckin Coffee, a Chinese company listed in NASDAQ. The research is exploratory and based on publicly available information. The financial data has been obtained from their quarterly and annual reports submitted to Securities and Exchange Commission. The research shows the alleged corruption by inflating sales and profits by C-suite executives of the company. Nevertheless, before doing so, what failures in corporate governance led to this crisis? The admission of such material misstatements resulted in a massive loss to the investors and shaken the investment community's trust once again. The research tried to determine what kind of audit procedures should have been implemented to earlier detection of fraud? What should have been done to protect stakeholders? What extra measures should the U.S. stock exchange take into consideration before listing foreign companies? What kind of ethical standards must be taught to the students/future executives to avoid such material misstatements? How can accounting bodies address such material misstatements? How can audit procedures be improved? This research will facilitate the policymakers, accounting and auditing regulators, board and various other stakeholders to deter, detect and mitigate such financial material misstatements and offers recommendations.

Keywords: Accounting Scam, Analytical Procedures, Audit Procedures, Confirmation Procedure, Material Misstatements.

JEL Classification Codes: M41, M42, M48, M148.

INTRODUCTION

In October 2017, the war of market share of coffee sales started in China after the foundation of Luckin Coffee, a new startup, by Jenny Qian Zhiya. Jenny wanted to introduce coffee as part of life to the Chinese people. She believed that tea drinkers dominated the Chinese market, yet there were ample opportunities in the untapped coffee market. Jenny always gave credit to caffeine for her ability to work overtime in her jobs. She was in the firm belief that there is space for another coffee selling company that can position itself in front of international coffee market players such as Starbucks and Costa.

Along with Jenny, the CEO, Jian Lu, the COO, and Reinout Hendrik Schakel, the CFO pledged to write Luckin's success story. However, on April 2, 2020, the announcement of the inflated sales by the COO was on every newspaper's headline. The COO admitted a huge inflated sale of Q3 and Q4 of 2019 sales and overstated marketing expenses. It turned the super success story into a failed one.

When introducing coffee to an audience bound to tea through religion, culture, and history and having competitors that took ground in the coffee industry for many years, it might be a tough job for many. However, Jenny, Jian, and Reinout made it look like a piece of cake when the number of stores jumped from 1,300 in October of 2018 to 4,507 at the end of 2019, which crushed Starbucks store number who entered the market in 1999 and had 4,200 stores (J. Wang, 2020). Surprisingly, that is a small ratio of the eye-watering growth demonstrated by Luckin coffee.

The retail trader "Wall street bets" was a happy trader after placing a trade at $49, and he might have felt "Luckin" as the company was the greatest, and it was releasing astonishing numbers (Winck, 2020). Although Luckin stands for luck, Wall Street bets were not lucky when the stock took an 80% nosedive on April 2, 2020, which cost him $252,000 or, in other words, his whole life savings.

Brief Profile of the Management

Jenny Zhiya was the founder and CEO of Luckin Coffee. She served as a former Operations Executive at UCAR, an on-demand chauffeured car service.

Jian Liu served as Head of Yield Management before taking on the positing of Chief Operating Officer at Luckin coffee.

Reinout Hendrik Schakel was an Executive Director of Consumer & Retail at Standard Chartered Bank, before taking on the position of CFO at Luckin, and still has a job as CFO in Ruixing Coffee Bejing Co Ltd. Reinout, unlike the CEO and COO, was not terminated from his position at Luckin Coffee to date.

Coffee Found a Home at China

Emerging markets like China, Brazil, and India have witnessed changing demographics, cultural transformations, and economic growth (Javalgi & Grossman, 2016). In addition to a rising middle class, all those prospects combined make emerging markets attractive for international investors worldwide (Ferreira & Ferreira, 2018). According to the coffee market analysis, the growth rate of coffee consumption in China is 20% annually, which is 2% above the global growth rate (COFFEBI, 2019). The International Coffee Organization (ICO) also stated that "the rising popularity of coffee shops and coffee culture, in general, is promoting growth in fresh roast and ground coffee (Global Coffee Report, 2019). As the Chinese become more interested in coffee, coffee brands have become more involved in China.
So why is coffee consumption growing? We have five simple answers:

- Increasing interest from young professionals
- Better standard of living and the rise of the middle class
- Hundreds of coffee shop openings
- An increase in the number of local coffee houses
- An increased interest in professionalism in coffee service and ceremonies

China has witnessed three waves of coffee; the first wave was through fast food and home outlets, the second was through dedicated coffee chains, and the third through speciality coffee shops (Ferreira & Ferreira, 2018).

The Rise of Luckin Coffee and Significant Competitors

0 to 4,500 locations in 2 years are one of many ways to describe this company. They defined themselves as the second-largest and fastest-growing coffee company in China in a short span. Luckin was highly technology-driven; their prospectus mentioned the word technology more than five times than the word bean. Their retail model built around mobile apps and store networks. The entire customer purchase process goes through on mobile apps, which facilitated a 100% cashier-less environment. The store network operated three types of stores, and their strategic focus was their pick-up stores. These stores had limited seating and were in areas with a high demand for coffee, such as university campuses, office building, and commercial spaces. The company went public on May 17, 2019, on Nasdaq. The pricing for the shares it offered ranged between $15-$17 with the hopes of raising more than $500 million.

The company witnessed rapid growth, and much of its growth resulted from its aggressive marketing strategy. After just one year in business, it was challenging, long term global coffee player, Starbucks, aiming for 4,500 outlets by the end of 2019. It exceeded the number of costa coffee stores by October 2018. The company had 4,260 locations on November 11, 2019, equivalent to Starbucks (Fruhlinger, 2019). It reported 6,500 locations in China in April of 2020, which exceeded Starbucks by 2000 sites (Fruhlinger, 2020). The top 10 Luckin competitors were Starbucks, Mcdonalds, Costa Cofee, KFC, Burger King, Dunkin' Donuts, Subway, Pizza Hut, Café Coffee Day, and Wendy's.

The coffee e-retailer had explosive growth. It labelled itself as a "coffee network" as it used its recent funding technology innovation and business development (Smith, 2019). The CEO and founder had a straightforward goal of becoming the dominant coffee chain in China. Targeting the white collars young generation with cheap coffee and taste optimized for the Chinese consumer, Jenny Qian Zhiya focused on the two weak spots of the coffee industry in china "high prices and inconvenience"(Writers, 2018).

The business model embraced can be described as "grab-and-go." This aggressive model allowed to open over 4500 stores. The idea is to order via an app, and the customer will be directed to a location near them. The executives chose the cash-burning strategy, which they implied with CAR Inc. more than a decade ago; they burned money from investors to quickly grab market share from rivals.

Luckin's business model was the opposite of Starbucks, which based on social interaction. They adopted the idea that the customer wants their coffee, but social interaction not so much. Professor Jeffrey Toson described Starbuck's strategy as being based on real estate, where Luckin's based on smartphones. When customers signed up for the first time in the Luckin app, they got their first free coffee. Although free is always valued, it has its downfalls as well. Luckin suffered considerable losses in 2018 and 2019. The losses were even more significant in 2018, with a revenue of 840.7 million yuan and a net loss of 1.619 billion yuan (Markoch, 2020). The Luckin Coffee earnings report included a net loss of -$74.41 million in 2019, which is 7.78% worse than its third-quarter loss in 2018, $69.04. The 2019 results reported misleading, so it is difficult to estimate the losses of 2019 precisely.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Luckin's stock had more than coronavirus to worry about when it was subjected to a sell-off on January 31, 2020, upon the release of an 89-page anonymous report by Muddy Waters Research stating that the company has a "fundamentally broken business" and accused it of "fraud"(Aiden

Research, 2020). The company's stock sunk as much as 27% that day (Finman & Yang, 2020). However, that was only the beginning.

Luckin found itself in the middle of a battle when Citron Research also claimed on Twitter that they had received the same anonymous report given to Muddy Waters Research. Still, they stated that "they are long LK" as research findings do not "mesh" with current data. They also stressed that they were waiting for LK's management response"(Fineman, & Yang, 2020). Luckin issued a response to the short thesis by Muddy Waters, stating that "the methodology of the report is flawed the evidence is unsubstantiated, and the allegations are unsupported speculations and malicious interpretations of events" this headline represented a catalyst to LK's stock and kept it "moving"(Newdesk & Writer, 2020).

Many lives changed on April 2, 2020. The CEO and COO were fired, and "Wall street bets" lost his life savings when the stock sunk as much as 81% when the fraud conducted by LK's COO and other employees was on every financial headline.

Their internal investigation found that 2.2 billion yuan inflated sales from the second quarter to the fourth of 2019 (Business News, 2020). Interestingly, this announcement was made shortly after appointing two new independent directors to the company's board. The first was Tianruou, who had over 20 years of work experience. The second was Wai Yuen Chong, who had above 30 years (Luckin Coffee Inc., 2020).

Initially, the COO accused of financial misconduct. Nasdaq exchange halted trading of Luckin Coffee's stock for news pending on April 7, 2020, at 9:15 Eastern Time at the last price of $4.39. The company's status changed to "additional information requested" by NASDAQ.

What went wrong with Luckin coffee? Everything? The short research report released by Muddy Waters Research report covers it nicely and in great detail. The report split into two areas: Fraud and the fundamentally broken business. We discuss the five primary pieces of evidence mentioned in their report.

Evidence #1: Sales figures were inflated by 69% in the Q3 of 2019 and by 88% in Q4 of 2019, supported by 11,260 hours of traffic video. Muddy had employed 92 full-time staff and 1,418 part-time staff to record store traffic for 981 store days covering 100% of the operating hours for 620. Luckin had 4,507 stores in 53 cities, and muddy waters covered 38 towns that had 98% of Luckins stores. They also categorized the stores into malls, schools, residential, transportation, hotel, and others. The research company eliminated footage that missed more than 10 minutes and ended up with a success ratio of 54% with 100% integrity. For every 981 days, they counted the number of customers picking up Luckin products and the number of orders picked y delivery personnel.

In addition to that, they also found that Luckin inflated an average of 72% of online order volumes. All orders placed and paid online. When an order was placed, a three-digit number generated in addition to a QR code. Through the random selection of 151 offline tracking store days to track their online orders, they found out that the number of online orders inflated from a range of 34 to 232, and an average of 106 orders per day or 72% of the average of offline orders.

Evidence #2: The research firm reported a decline in the items per order from 1.38 in 2019 2Q to 1.14 in 2019 Q4. Muddy gathered 25,843 customer receipts from 10,119 in 2,213 stores in 45 cities. The importance of delivery has also declined during the period. Cite research stated that transportation is roughly 10% of the business on January 14, 2020.

Evidence #3: Muddy gathered 25,843 receipts and found that Luckin inflated their net selling price per item by 12.5%.

Evidence #4: Muddy found that Luckin overstated its 3Q advertising expenses by 150% through third party media.

Evidence #5: Muddy found nearly a 400% inflation on the revenue that Luckin labelled as other products.

The following hypotheses are developed based on the literature review as follows:

- The sales revenue misstatements have an impact on the performance disclosures of the firm.
- The expenses misstatements have an impact on the performance disclosures of the firm.

PROBLEM STATEMENT

Luckin Coffee's CEO's first violation was the inflation of sales revenue, representing a violation of the revenue recognition principle. If the sales revenue has been overstated, it will overstate the profits. It seems there was negligence on the part of EY, the auditors. If auditors applied proper audit procedures (especially analytical procedures for purchase and sales), there was enough possibility of getting red flags. The misreporting could be detected earlier if the audit was done professionally. EY, the auditor from the beginning, refused to comment on any reporting matters due to the client's confidentiality.

CONCEPTUAL FRAMEWORK

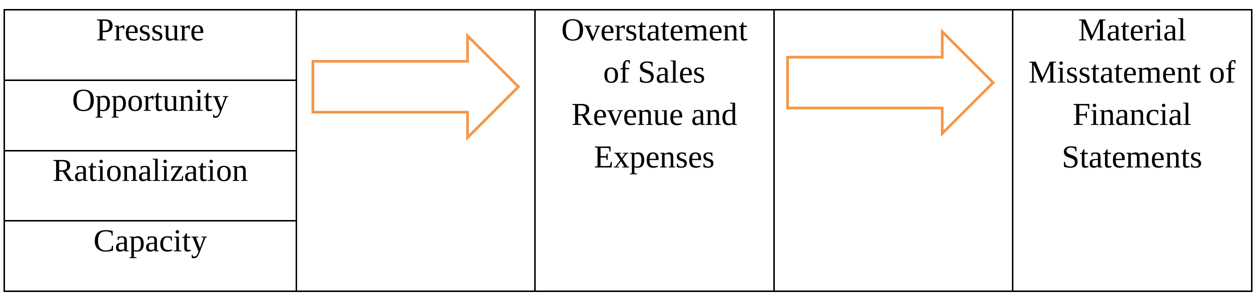

Figure 1. Conceptual Framework

Source: Created by the author

RESEARCH METHODOLOGY

This research is exploratory and qualitative. The research information collected from various credible sources such as investigation reports of investigating agencies, whistleblower reports, financial data from the Securities and Exchange Commission, reputed newspapers, business magazines, etc. The information verified by corroborating evidence and comparing the information from other sources.

OBJECTIVES OF THE RESEARCH

This research aims to examine and investigate the material misstatements done by the senior management of the company. It attempts to figure out the loopholes used in accounting and auditing standards and practices that the few senior executives exploited. It touches upon the failure of fiduciary duties of the board while performing their duties. It deals explicitly with the violation of revenue recognition and matching principles. It will further highlight such an alleged scam's dominos effects on various stakeholders' interest, especially shareholders.

DISCUSSIONS

Financial material misstatement is not new to the world of business. There are several material misstatement cases, but one or more of the four motives mentioned in diamond theory exist in all cases. Luckin is no exception to it. The high ambitions of senior management encourage them to indulge in a financial material misstatement.

Trading for LK's stock is currently going on over the counter. Investors had the option to either hold onto the ownership or sell the stock. Nasdaq issued the delisting notice for the reason of "public interest concerns as raised by the fabricated transactions disclosed by the company" and "the company's past failure to publicly disclose material information, citing a business model through which the previously disclosed fabricated transactions executed"(Fantozzi, 2020). Chinese market regulators have also started an investigation into LK's operations, and the company was said to be assisting their work (Y. Wang, 2020).

The Chinese government is said to be shielding U.S. listed Chinese companies from complying with the SEC procedures of audit and disclosure. Senate Marco Rubio stressed that "of the Chinese companies want to be listed on the U.S. exchanges, they must comply with American laws and regulations for financial transparency and accountability.

Table 1. Timeline of Significant Events

Dates	**Major events**
October 2017	Luckin Coffee was incorporated.
January 2018	It opened its first shops in Beijing and Shanghai (Yoon, 2018).
May 2018	Luckin accused Starbucks of monopoly by signing exclusive contracts with suppliers and property owners.
May 16, 2018	The case was put on file by Shenzen Intermediate People court.
July 2018	The company announced the completion of Series A financing (International Finance News., 2018).
September 2018	Tencent signed a partnership with Luckin (Chan, 2018).
October 2018	Luckin Coffee opened 1300 stores and surpassed the number of Costa shops (Xinghua, 2018).
November 2018	The company had its second fundraising.
January 2019	Luckin announced its plan to open 2500 stores and become the most significant coffee brand in China.
April 2019	The company had its Pre-IPO funding.
May 2019	Luckin Coffee IPO announced in Nasdaq.
May 29, 2019	The company released Q1 2019 earnings results.
August 14, 2019	The company released Q2 2019 earnings results.
October 2019	Luckin withdrew a monopoly case against Starbucks.
November 13, 2019	The company released Q3 2019 earnings results.
December 2019	The company was exceeded Starbucks by the number of stores.
January 2020	Expansion to vending machines.
January 31, 2020	Muddy Waters report published on Twitter.
April 2020	The company admitted the fabrication of sales.
April 7, 2020	Nasdaq halted LK shares trading.
May 15, 2020	Delisting notice issued by Nasdaq.
June 24, 2020	Luckin withdrew delisting hearing requests.
June 29, 2020	The trading of shares suspended.

CONCLUSION

The Luckin scandal shook the investors again after a long series of scandals from across the world. This scandal brought governance issues in the centre stage. An overambitious attitude of the few people at executive management brought trouble to thousands of investors, employees, suppliers, etc. This case raised very pertinent questions on the ability and practices of the audit firm, EY. Again it is proved that tight regulations are also not sufficient unless they are executed in true spirit. Even the best internal controls can't detect frauds if top management colludes.

In addition to inflating sales, marketing costs and expenses were also overstated (Pisani, 2020). Auditing procedures were a weak point in oversight. Jay Clayton and William Duhnke III, the Public Company Accounting Oversight Board chairman, stressed that U.S. regulators were often prevented from inspecting Chinese firms' audit work and practices. They have called for more cooperation from China.

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